



0000042442

ORIGINAL

MEMORANDUM

RECEIVED

2002 FEB 25 P 2:32

AZ CORP COMMISSION
DOCUMENT CONTROL

TO: Docket Control
Arizona Corporation Commission

FROM: *EJ*
Ernest Johnson
Director
Utilities Division

DATE: February 22, 2002

RE: IN THE MATTER OF VARTEC TELECOM, INC., EXCEL
TELECOMMUNICATIONS, INC., EMERITUS COMMUNICATIONS, INC.,
AND LONG DISTANCE WHOLESALE CLUB, INC.- FILING FOR AN
EXEMPTION FROM A.R.S. 40-285 AND WAIVER OF THE PUBLIC UTILITY
HOLDING COMPANIES AND AFFILIATED INTERESTS RULES (DOCKET
NOS. T-03401A-01-0952, T-02584A-01-0952 AND T-03188A-01-0952)

Attached is the Staff Report for the above referenced application. Staff recommends approving the application without a hearing.

Originator: John S. Thornton

Attachments: original and eleven copies

Arizona Corporation Commission
DOCKETED

FEB 25 2002

DOCKETED BY	<i>nc</i>
-------------	-----------

Service List for VarTec Telecom, Inc. et alia
Docket Nos. T-03401A-01-0952, T-02584A-01-0952,
& T-03188A-01-0952

VarTec Telecom, Inc. et alia
James U. Troup
McGuire Woods LLP
Washington Square
1050 Connecticut Avenue, N.W.
Suite 1200
Washington, D.C. 20036-5317

Christopher C. Kempley, Esq., Chief Counsel
Legal Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Ernest G. Johnson, Esq., Director
Utilities Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

Lyn Farmer, Esq., Chief Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 West Washington Street
Phoenix, Arizona 85007

**STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION**

**VARTEC TELECOM, INC.
EXCEL TELECOMMUNICATIONS, INC.
EMERITUS COMMUNICATIONS, INC.
LONG DISTANCE WHOLESALE CLUB, INC.**


**DOCKET NOS.
T-03401A-01-0952
T-02584A-01-0952
T-03188A-01-0952**

**APPLICATION FOR EXEMPTION FROM A.R.S. 40-285
AND
WAIVER OF THE PUBLIC UTILITY HOLDING COMPANIES AND
AFFILIATED INTERESTS RULES**

FEBRUARY 2002

STAFF ACKNOWLEDGMENT

The analysis contained in the Staff Report for the application of VarTec Telecom, Inc. et alia for exemption from A.R.S. 40-285 and waiver of the Public Utility Holding Companies and Affiliated Interests Rules, Docket Nos. T-03401A-01-0952, T-02584A-01-0952, T-03188A-01-0952 was prepared by John S. Thornton.



John S. Thornton
Chief, Accounting & Rates

EXECUTIVE SUMMARY
VARTEC TELECOM, INC. ET ALIA
DOCKET NOS. T-03401A-01-0952, T-02584A-01-0952, T-03188A-01-0952

On December 4, 2001, VarTec Telecom, Inc., Excel Telecommunications, Inc., eMeritus Communications, Inc. and Long Distance Wholesale Club, Inc. ("Applicants") filed an application for an exemption from A.R.S. 40-285 and a permanent general waiver of the Arizona Corporation Commission ("Commission") Public Utilities Holding Company and Affiliated Interests Rules A.A.C. R14-2-801 through 806 ("Rules"). The Applicants filed a joint application because VarTec Telecom, Inc. is in the process of directly or indirectly acquiring all the capital stock of Excel Telecommunications, Inc., eMeritus Communications, Inc. and Long Distance Wholesale Club, Inc., other Arizona public service corporations.

Exemption from Arizona Revised Statute ("A.R.S.") 40-285 is beyond the statutory authority of the Commission but it can grant authority under A.R.S. 40-285 for the proposed transaction. The Commission has granted waivers of A.A.C. affiliated interests rules for competitive telecommunications companies and others.

Staff recommends the following:

- A.R.S. 40-285 (D)—The Commission should grant VarTec the authority, pursuant to A.R.S. 40-285 (D) to directly or indirectly acquire the capital stock of Excel Telecommunications, Inc., eMeritus Communications, Inc. and Long Distance Wholesale Club, Inc.
- Rule R14-2-803—The Commission should grant the Applicants a waiver from Rule R14-2-803 unless organization or reorganization could directly or indirectly result in or cause an increase in the Applicants' maximum rates on file with the Commission for any competitive service.
- Rule R14-2-804—The Commission should grant a waiver from Rule R14-2-804 (B), (C) and (D) except for transactions that could directly or indirectly result in or cause an increase in the Applicants' maximum rates on file with the Commission for any competitive service.
- Rule R14-2-805—The Commission should grant a waiver from Rule R14-2-805 unless diversification plans could directly or indirectly result in or cause an increase in the Applicants' maximum rates on file with the Commission for any competitive service.

Staff does not recommend a hearing in this docket.

TABLE OF CONTENTS

	<u>Page</u>
Introduction	1
The Companies	1
The Transaction	1
The Applicants' Request	2
The Purpose of the Public Utility Holding Companies and Affiliated Interests Rules .	2
R14-2-803	3
R14-2-804	3
R14-2-805	3
Decision Nos. 62582 and 62702	4
Recommendations	4

Introduction

On December 4, 2001, VarTec Telecom, Inc. ("VarTec"), Excel Telecommunications, Inc. ("Excel"), eMeritus Communications, Inc. ("eMeritus"), and Long Distance Wholesale Club, Inc. ("LDWC") (collectively referred to as "Applicants") filed an application for an exemption from Arizona Revised Statute ("A.R.S.") 40-285 and a permanent general waiver of the Arizona Corporation Commission ("Commission") Public Utilities Holding Company and Affiliated Interests Rules Arizona Administrative Code ("A.A.C.") R14-2-801 through 806 ("Rules"). The Applicants filed a joint application because VarTec is in the process of directly or indirectly acquiring all the capital stock of Excel, eMeritus, and LDWC.

Exemption from A.R.S. 40-285 is beyond the statutory authority of the Commission but the Commission can grant authority for the acquisition under the statute. Therefore, Staff interprets the Applicants' petition as a request for authority to effect the acquisition under A.R.S. 40-285. A.A.C. R14-2-806 allows for a waiver from the affiliated interests rules. Rule R14-2-801 provides definitions under Article 8. R14-2-802 defines Article 8's applicability. Therefore Staff interprets the Applicants' petition as a waiver from Rules R14-2-803 to -805.

The Companies

Through various decisions, VarTec, eMeritus, Excel, and LDWC were authorized by the Commission to provide intrastate inter-exchange telecommunication services throughout Arizona. VarTec also provides competitive local exchange services in seven states, eMeritus provides competitive local exchange services in 27 states, and Excel provides competitive local exchange service in 37 states.

In Arizona, the Applicants compete directly with numerous competitive inter-exchange carriers, such as AT&T and MCI WORLDCOM. The Applicants do not have captive customers, and their customers are free to obtain telecommunications services from other carriers that provide the same services.

The Transaction

VarTec, through a stock purchase agreement dated August 26, 2001, will acquire all the capital stock of Excel Communications Inc., which controls 100% of the equity of Excel, eMeritus, and LDWC. VarTec will effect the transfer through a newly created subsidiary, VarTec Holding. A.R.S. 40-285 applies because VarTec is an Arizona public service corporation acquiring the capital stock of other Arizona public service corporations.

The Applicants' Request

The Applicants request a permanent general waiver of A.R.S. 40-285 and the Commission's application of the affiliated interest rules to allow the transaction to be effected. In the alternative of a full exemption from the Rules, the Applicants seek a partial waiver of the Rules that would result in a public benefit outweighing the "burden of partial compliance."

The Applicants believe they should have a permanent general waiver from the Rules for several reasons. First, they believe that, due to market forces in effect in Arizona, they will have no incentive or ability to charge unduly high or above-market prices that could be used to fund or subsidize unregulated affiliates. Neither would they be motivated to co-mingle utility and non-utility funds in a manner that is harmful to Arizona customers when customers have easy access to a different provider. The Applicants also argue that the rates of AT&T, Sprint, and MCI effectively set limits on the rates the Applicants could charge.

The Applicants maintain that when a public utility participates in a competitive market and holds non-monopoly power, application of the Rules is unnecessary and that because the Applicants are not monopolies they do not have the ability to improperly capitalize or subsidize the businesses of its non-regulated affiliates.

Depending upon the interpretation of the Rules, the Applicants could fall under the purview of R14-2-803 requiring notice to the Commission every time each of them "reorganized." The Applicants believe that the Rule's filing requirements would be unnecessarily burdensome. The majority of affiliate transactions will be national or pertain exclusively to interests in other states because the Applicants' revenues and investment in Arizona will comprise only a small portion of their total corporate family revenues and investment. Therefore, the Applicants believe the application of the Rules is unnecessary.

The Applicants request that the Commission's decision on these applications be issued retroactively to the date on which the Rules became applicable to the Applicants because they might have become Class A public utilities either before or during the processing of this case.

The Purpose of the Public Utility Holding Companies and Affiliated Interests Rules

Prior to and during 1990, Arizona Public Service Company ("APS") formed a holding company, Pinnacle West Capital Corporation, and it acquired MeraBank. Huge losses were experienced by MeraBank, resulting in downgrades of APS's bond rating and increases in APS's cost of capital. At the same time, Southwest Gas Corporation purchased PriMerit, a savings bank, and Tucson Electric Power Company ("TEP") diversified into several non-utility related activities.

Decision No. 56844, dated March 14, 1990, first adopted the Public Utility Holding Companies and Affiliated Interests Rules found in Article 8 of the Commission's Rules. Attachment B to the Decision was a concise explanatory statement that described and explained the Rules. The statement explained that "Its [Article 8's] singular purpose is to ensure that ratepayers do not pay rates for utility service that include costs associated with the holding company structure, financially beleaguered affiliates, or sweetheart deals with affiliates intended to extract capital from the utility to subsidize non-utility operations."

The Commission recognized the limitations of the Rules in a competitive environment when it approved settlement agreements relating to electric restructuring. These agreements significantly reduced the notice and filing requirements and applied the Rules primarily to the utility distribution company and not to the affiliates. The filing of an affiliate's plans for diversification, and other reporting requirements, were waived as a part of the settlement.

R14-2-803

Rule R14-2-803 requires a utility or affiliate to give advance written notice of intent to organize or reorganize a public utility holding company. R14-2-801 broadly defines reorganization as "the acquisition or divestiture of a financial interest in an affiliate or a utility, or reconfiguration of an existing affiliate or utility's position in the corporate structure or the merger or consolidation of an affiliate or a utility." This can be interpreted to mean that every time Applicants or an affiliate creates or divests itself of a subsidiary, regardless of the business purpose or location of the subsidiary, a notice of intent would need to be filed with the Commission.

R14-2-804

Rule R14-2-804 (B), (C) and (D) requires prior Commission approval of certain transactions undertaken by the utility including obtaining an initial financial interest in an affiliate, guaranteeing or assuming liabilities of affiliates or increasing or decreasing a financial interest in an affiliate. Rule R14-2-804 (A) refers to Commission access to an affiliate's books and records. Staff does not recommend approving a waiver from R14-2-804 (A).

R14-2-805

Rule R14-2-805 requires all public utility holding companies and Class A public utilities in Arizona to file their diversification plans annually. Along with these plans, the utilities must file other information including, but not limited to, financial statements for each subsidiary, a description of the plans for the utilities' subsidiaries to change business activities, an assessment of the effect of planned affiliated activities on the utility's

capital structure, the bases upon which the holding company allocates costs, the dollar amount transferred between the utility and each affiliate, and most contracts between affiliates and the utility.

Decision Nos. 62582 and 62702

Decision No. 62582, dated May 17, 2000, approved a partial waiver of the Rules for Cox Arizona L.L.C. ("Cox Arizona") and its affiliates. Decision No. 62702, dated June 30, 2000, approved a partial waiver of the Rules for various affiliates of MCI. The aforementioned applications were nearly identical to the application in these dockets. Cox Arizona, MCI, and their affiliated companies are large telecommunications enterprises with many affiliates and inter-affiliate transactions. These entities and their affiliates form and divest affiliates on a routine basis.

Recommendations

Staff recommends the following:

- A.R.S. 40-285—The Commission should grant VarTec the authority, pursuant to A.R.S. 40-285 (D), to directly or indirectly acquire the capital stock of Excel Telecommunications, Inc., eMeritus Communications, Inc. and Long Distance Wholesale Club, Inc.
- Rule R14-2-803—The Commission should grant the Applicants a waiver from Rule R14-2-803 unless organization or reorganization could directly or indirectly result in or cause an increase in their maximum rates on file with the Commission for any competitive service.
- Rule R14-2-804—The Commission should grant the Applicants a waiver from Rule R14-2-804 (B), (C) and (D) except for transactions that could directly or indirectly result in or cause an increase in their maximum rates on file with the Commission for any competitive service.
- Rule R14-2-805—The Commission should grant the Applicants a waiver from Rule R14-2-805 unless diversification plans could directly or indirectly result in or cause an increase in their maximum rates on file with the Commission for any competitive service.

Staff does not recommend a hearing in this docket.